

California Department of Corporations

LOOK BEFORE YOU LEAP A Guide to Buying a Franchise



[DEPARTMENT OF **CORPORATIONS**

California's Investment and Financing Authority

Governor Arnold Schwarzenegger
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I. Introduction

Many individuals view franchising as a quick and easy way to start their own business. However, the purchase of a franchise takes a substantial sum of your money and provides no guaranteed path to success. By investing the time and effort to read this guide, you are doing the single most important thing you can do as a potential franchisee, educating yourself.

Any success you may have in franchising is essentially a combination of factors: your drive and ambition and the care with which you select a franchise. The purpose of this guide is to provide you with valuable insight into the world of franchising. Read this information to help you evaluate some of the issues that arise in considering a franchise business.

Franchising is founded on open and honest relationships between you and the franchisor and on realistic expectations about the franchised business. There is no better way to ensure a mutually successful franchise relationship than for you and the franchisor to enter into the business fully aware of each other's rights and obligations.

The California Department of Corporations has developed this guide to assist you in making an informed decision as you choose your franchise, which may help make your business a success.

NOTE

THIS FRANCHISE GUIDE IS **NOT** PROVIDED FOR THE PURPOSES OF GIVING LEGAL, ACCOUNTING OR FINANCIAL ADVICE. IT IS YOUR RESPONSIBILITY AS THE POTENTIAL FRANCHISEE TO THOROUGHLY INVESTIGATE AND RESEARCH A FRANCHISE OPPORTUNITY TO MAKE AN INFORMED DECISION.

READING THIS FRANCHISE GUIDE IS A GOOD BEGINNING, BUT WE ENCOURAGE POTENTIAL FRANCHISEES TO SEEK PROFESSIONAL ADVICE THROUGHOUT THE EVALUATION OF A FRANCHISE OPPORTUNITY.

II. Make an informed decision

Many people dream of being an entrepreneur. By purchasing a franchise, you have the opportunity to sell goods or services that may have instant name recognition and to be assisted by a system that may provide you with training and continuous support. As with any investment, you must proceed with caution and educate yourself. Purchasing a franchise carries no guarantee of success.

You can reduce the risk of failure by being an informed buyer and properly researching franchise opportunities. Remember, you will be committing your

time and money to a business relationship that may involve a significant part of your life. That is why it is important to become informed **before** you invest your money.

All the information provided in this guide will prove worthless if you do not thoroughly research the franchise opportunity and discuss your plans with your attorney and accountant **before** paying out any money or signing a contract. Responsible franchisors want good franchisee relations. You can help foster good relations by educating yourself about how to avoid unnecessary misunderstandings, and by evaluating the franchise opportunity before you enter into a business for which you may not be suited. Remember, solid preparation, rational risk-taking, and the ability to make well-reasoned decisions is crucial to your success.

III. What is a franchise?

A franchise is an agreement that grants you the right to sell goods or services under the franchisor's method of operation ("marketing plan"). It involves the use of the franchisor's trade name (or similar mark or symbol) and the payment of a "franchise fee." The franchise fee is commonly paid by you, the potential buyer or the franchisee, when you sign the franchise agreement. Ongoing royalty payments are generally also required. You can obtain more information on what constitutes a franchise at the Department of Corporations' website at www.corp.ca.gov.

You, as the buyer, rely upon the experience and capability of the company selling the franchises, or "franchisor." When choosing a franchisor, find one capable of providing you with the necessary preliminary assistance as well as continuing support. The information provided in this guide is intended to assist you in this choice.

IV. What is the UFOC?

If you appear to be a good candidate for the franchise, the franchisor will send you a Uniform Franchise Offering Circular ("UFOC" or "Offering Circular"). Generally, the Federal Trade Commission (FTC) and California law require that the franchisor prepare this document so that certain information can be disclosed to a potential franchisee **before** a franchise agreement is signed or any payment is made.

Any franchisor that is subject to registration in California is required to give you a UFOC. This document tells you all about the business you are considering. The franchisor **must** give you a UFOC at least 10 business days **before** you are required to either sign a contract or pay money to the franchisor.

The UFOC is a very important document. You and your professional advisors should read and understand the entire document. It has 23 "Items" that will provide many of the answers to questions you may have about the franchisor. And because the UFOC report is uniform, it will be easier to compare franchises.

V. Before you buy a franchise

Before you invest in a particular franchise, you should carefully consider some very important factors, such as your skills, financial capabilities and goals. The following list highlights some of the important considerations you should keep in mind. This list is meant to be a starting point to help you make an informed decision, and is by no means exhaustive.

A. Know your skills, capabilities and goals

1. Your skills

- What skills do you have or will the franchisor provide the relevant training?
- Does the franchise require technical experience or relevant education, such as auto repair, home and office decorating, or tax preparation?
- Are you willing to devote the extraordinary amount of time and money in a business you do not completely control and where the franchisor may dictate what you can and cannot do?
- Are you able to develop managing skills or will you have to hire managers?
- Will your personality allow you to interact well with customers?

2. Your capabilities

- Do you have the financial resources and emotional energy to start and sustain a business? You may experience an extended period of time when you pay out more than you take in.
- How much money can you afford to invest?
- How much money can you afford to lose?
- Can you get financing if you need it?
- Do you have money in savings or any additional income to live on while you start your franchise?

3. Your goals

- What are your goals?
- Do you require a certain level of income?
- Is there a particular field you are interested in pursuing?
- How many hours do you want to work?
- Do you want to run the franchise yourself or do you want to hire a manager?

B. Know your industry

- Have you thoroughly explored the industry you would like to be in?
- How well do you know the industry?

- Have you examined the various competitors within the industry, not just franchises? Are your experience, education and desire compatible with a particular industry?
- Have you researched how a particular product will do in a particular place?
- Does any local, state or federal government regulate your industry?
- Did you consider starting up your own business independently or buying an existing business instead of buying a franchise?

C. Know your franchisor

- How long has the franchisor been in the actual business that you will operate? Is the franchisor merely in the business of franchising?
- What is the franchisor's past and present financial situation, including any litigation history?
- Evaluate the franchisor's ability and willingness to meet all contractual obligations.
- Is the business dependant on trademarks, patents or copyrights that will soon expire?
- Who are the principal management people? There is no substitute for qualified management.
- How long has the management been with the franchisor?
- What prior experience do these people have?
- Has the management been involved in any bankruptcy proceedings?
- Has the management or the franchisor ever been the subject of legal action by law enforcement or regulatory agencies? If so, why?
- Ask the franchisor for a list of references.
- See what creditors think of the franchisor.
- Review the franchisor's financial statements.
- How many franchises have been closed or terminated? Why?

D. Questions to ask existing and former franchisees

Call and visit several branches of the franchise. Be considerate of the people you speak to. They do not have to talk with you and you cannot expect them to take time out of their busiest hours. Explain who you are and ask when would be a good time for them to speak with you. Have questions ready.

1. Questions to ask an existing franchisee:

- Why did you select this particular franchise system over others in the same type of business?
- What was your employment background prior to becoming a franchisee?
- Have you encountered any problems with the franchise as a whole, including the franchisor, the site, the business plan, etc.?
- How does the franchisor respond to problems?
- Did you get the training, products and support you paid for and were promised? Did the promised training take place when you needed it and

did the training prepare you to adequately compete with other businesses providing similar products or services?

- How would you describe your overall franchisor/franchisee relationship?
- Is there a franchisee association or advisory council?
- Are there any other franchisees or former franchisees that you recommend I contact?
- Consider asking a cooperative franchisee if you could work with her/him for a period of time for free before you commit to buying your own franchise.
- Consider asking a cooperative franchisee if he/she would still purchase this franchise today if he/she had it to do over again?

2. Questions to ask a former franchisee:

- Why did you leave the business?
- Did the franchisor cooperate in helping you sell your franchise?
- Do you own any other franchises or would you buy a franchise from a different franchisor?
- If there was a termination or non-renewal, did the franchisor explain why and provide a reasonable opportunity for you to cure the problem?

E. Watch out for fraud: tips and warning signs

1. Failure of the franchisor to disclose all necessary documents and details. The franchisor that does not properly disclose all relevant details to you is probably trying to hide something. The franchise may not be profitable or the franchise may be a scam. Before you sign anything, be sure to learn all of the relevant information, make sure all of your questions are answered fully and be certain that all relevant details are clear.
2. The use of high-pressure sales tactics. You should never feel that the franchisor is pressuring you to buy a franchise. Keep in mind, this is your money you are investing - be cautious.
3. Franchisor claims of minimal risk and promises of unrealistic profits. Even the franchisor with the most successful chain cannot legitimately promise that you will make money. There is always a large risk in buying a franchise, so be careful of claims that seem too good to be true or any assertions by the franchisor that there is little risk.
4. The charging of unjustified start-up fees. Initial fees are sometimes very high so you should make sure you know exactly where your money is going. Many crooked franchisors have sold franchises and disappeared with the initial franchise fee.
5. Consult your professional advisors. Use of professionals like business advisors, accountants and attorneys may help in detecting fraudulent activity. The money you spend obtaining advice before you invest may help you avoid a bad investment situation.

VI. Some insight into knowing and understanding your franchise agreement

Investing in a franchise can be very costly. In order to better understand the terms and conditions of your franchise agreement, you should consult with your professional advisors.

For instance, an accountant can help you to better understand the company's financial statements, develop a business strategy, and assess any earnings projections and the assumptions upon which those projections are based. In addition, an accountant can help you pick a franchise that is best suited to your skills, capabilities and goals.

Franchise agreements can be long and complicated. Any problems that you may have after the agreement is signed can be extremely expensive or impossible to fix. Retaining the services of an attorney who is experienced in franchise or contract matters will help you to understand your rights and obligations under the franchise agreement **before** you sign.

A. The franchisee's obligations

As a potential franchisee, you must be prepared to make a large initial investment (including the initial franchise fee, real estate, improvements, licenses, utilities, insurance, transportation, etc.) and pay ongoing operating costs and royalty fees. The available financing arrangements offered by the franchisor, if any, and your estimated initial investment are contained in the UFOC. The UFOC also contains information regarding your obligations to buy or lease from the franchisor or a supplier designated by the franchisor. The UFOC should be read thoroughly and your franchise agreement reviewed by your professional advisors.

Make sure you understand the circumstances under which you and your family members may be held personally liable under the provisions of the franchise agreement. Additionally, if there are any restrictions in the franchise agreement, make sure you understand their full nature, including how restrictions affect ownership, what you can or cannot sell, employment, participation in competitive businesses, current and future business interests of you and your family, etc.

Below is a brief outline of several components of a typical franchise.

1. Initial franchise fee

Your initial franchise fee, which is typically paid up front and may be non-refundable, may cost nothing to several hundred thousand dollars. In some cases, the franchise fee is payable in installments, but the franchisor must disclose the terms of payment in the UFOC and franchise agreement.

2. Other costs or fees

You may also incur significant costs to open an outlet and to purchase your initial inventory. For a specific list of charges, you should refer to the franchisor's UFOC Item 6 and 7.

3. Financing

If any financing is available through the franchisor, the amount, interest rate, required collateral, potential liabilities upon default and any other terms and conditions must be included in the UFOC. Always keep in mind that you do not have to use the franchisor or its lender simply because they offer to help. As with any other type of loan or lease, you should shop around and compare loan and lease services at other financial or lending institutions to find the most favorable terms.

B. The franchisor's obligations

The franchisor's obligations lie in many different areas, such as obligations before you open your business, obligations during the term of your franchise agreement, obligations relating to site location, obligations to provide a training program, and an estimate of the length of time needed to open following the signing of a franchise agreement or the payment of the initial franchise fee to the franchisor.

If there is an operations manual, take the time to read and understand it completely. The manual contains the standards of operation the franchisor expects from you. Oftentimes you must sign a confidentiality agreement to keep the contents of the manual confidential. When you are examining it, always ask yourself, does this manual provide for all aspects of the business?

C. Things to consider

1. Location

One of the most important factors to consider when investing in a business is the location. It is very important that you know who is responsible for each step involved in selecting a site and who will pay the associated costs. Also, consider the importance of demographics. For instance, population statistics, vehicle counts, parking, pedestrian counts, competition, etc. could be very important factors to a business. Refer to UFOC Items 1, 11 and 12.

2. Territory

Make sure you know what your territory is in relation to other franchisees of your particular franchisor. Can the territory be changed? Are you going to have the opportunity to purchase new franchises next to or near your

territory before those sites are offered to others? For answers to these and many more related questions regarding your territory, refer to UFOC Item 12.

3. Advertising

Most franchisors require you to pay a certain amount of money each year into an advertising fund or to the franchisor directly for national or regional advertising campaigns. Having a national or regional advertising campaign is a big advantage to a franchise owner, since most local businesses cannot afford to advertise on the national or regional level. The advertising fee is usually determined based on a percentage of sales, although it is occasionally a flat rate. You may be asked or required to join a local or regional group that puts money into a fund for advertising in the area. Pooling money in this fashion is usually beneficial because it allows for more ads to be produced and for each one to be shown more often.

As with every other aspect of the franchise agreement, the advertising fee section requires cautious review before signing the contract. Some questions to consider include:

- How much advertising is necessary and how will it be paid for?
- Where does your money go?
- What happens to any extra money left over at the end of the year?
- Do franchisees have any input in advertising?
- Who creates the ads?
- Do all stores contribute at the same rate?
- UFOC Item 11 provides information on advertising costs.

4. Training

Another part of your evaluation of the franchise opportunity must include a realistic and practical assessment of what you know already and what you must learn. The franchisor will not usually teach you every aspect of successful business management. If you do not have any business experience whatsoever, you may not be ready for franchising.

If you and your advisors believe you are ready to run a business and the only question is which one, training is still important so that you learn the franchise operating system, how to comply with your franchise agreement, and how to take advantage of all the potential your chosen franchise has to offer. You need to determine what training you will need and then find out exactly what training the franchisor will provide, over what period of time and at what cost to you. What training is not provided that you need to have before opening your doors for business? Earnings claims (earnings potential)

The first question almost every potential franchisee asks is, "How much money will I make?" Franchisors are not required to include an earnings

claim in the UFOC; in fact, only a small number of franchisors do so. **If the franchisor does not make a claim of this sort, discussing ANY projected earnings is strictly prohibited.** For many reasons, the franchisor may elect not to include an earnings claim in the prospectus. For example, if the numbers turn out to be inaccurate or misleading, the franchisee could sue and the franchisor may even be held personally responsible and could face both civil and criminal charges.

If an earnings claim is made, franchisors must have a reasonable basis for these claims and must provide you with specified information under Item 19 of the UFOC that substantiates them. This information must include the bases and assumptions upon which earnings claims are made. Make sure you carefully review the documentation for any earnings claim.

Be skeptical about earnings claims. A franchisor will only make an earnings claim to portray the business in a positive light; for example, the franchisor may creatively use a small portion of franchised units in making the earnings claim. Determine how the franchisor arrived at the figures given to you. For the franchisees whose numbers were used, where is each business located? What is the competition there? How long has that branch been in business? What information is the franchisor not including? Also, understand that it takes a while for a new business to turn a profit, so even if you are given an earnings claim, you may not see that kind of profit for at least a few years, if ever. Refer to UFDC Item 19.

Regardless of any earnings claim made by the franchisor, investigate the costs and expenses you will incur in operating the franchised business. Franchisees and former franchisees, listed in the offering circular, may be one source of this information.

5. Dispute resolution

Both parties will probably want to settle disputes in the least costly, least time-consuming and least adversarial way possible. Arbitration is one option. The arbitration proceeding may be court-supervised or be held before a private third party. Many franchise agreements require arbitration as the sole means of dispute resolution. Refer to UFOC Items 17 and 22, and the UFOC cover page. If you are required to arbitrate, will the arbitration take place out-of-state or at a great distance from your site and at an extra cost to you?

Mediation is another method of dispute resolution. A mediator will facilitate the process and help both sides clarify their arguments, but will not make a judgment on the matter. The franchisor and franchisee will resolve the dispute themselves, making all of the major decisions together; therefore, none of the decisions made are binding.

The difference between arbitration and mediation is that an arbitrator renders a decision, which must be followed, while a mediator works cooperatively with the two parties, attempting to discern their needs and ultimately bring

them together. Mediation should be used only if you wish to continue operating as a franchisee. If there is little or no trust between you and the franchisor, mediation may only cause more trouble.

In some cases, it is necessary to have a court decide on an answer to your problem. Can you afford litigation? Will you be required to litigate in the jurisdiction where your business is located, or must you file suit in the state or county where the franchisor is located? This may vary; so make sure you are aware of the terms of the franchise agreement **before** you sign the franchise agreement. Also, refer to the UFOC cover page and UFOC Item 17.

D. Ending your franchise relationship

Eventually you may end up leaving the franchise for a number of reasons, perhaps because the franchisor terminated your relationship, the franchise term under your agreement expired, or because you or your estate transferred ownership to someone else.

1. Termination

The franchisor is usually allowed to terminate the agreement if there is just cause for doing so. This usually means that you failed to uphold part of the agreement that justifies the franchisor's decision to terminate. Make sure you understand each contract provision by which the franchisor can terminate your franchise agreement. Also, see what the contract says about the franchisor giving you notice of your failure to complete some aspect of the agreement; specifically, will you have time to correct the error before the franchisor moves ahead with the termination of the agreement?

2. Non-renewal

As with the termination clauses mentioned above, you may not be allowed to stay at your site in the event of non-renewal. Is your contract for a fixed period with no right to renew? Can the franchisor refuse to renew your franchise contract when the agreed-upon contract period ends?

3. Transfer

Some franchise agreements do not allow you to transfer the ownership of your franchise in any way, while others have specific rules governing it. Check your franchise agreement for the provisions relating to the transfer of your franchise. Your franchisor may have a right of first refusal if you decide to sell. This means that if a potential buyer makes an offer to you for your franchise business, the franchisor has the right to match the buyer's price and, in effect, buy out your business from under the potential buyer.

Your franchisor may also have the right to reject or not approve potential buyers. This can be extremely frustrating for a franchisee looking to sell and may also result in a franchisee selling his/her franchise for much less than he/she wanted.

New buyers do not want to come in at the very end of the term of your franchise agreement, they want to come in while your lease and franchise agreement still have many years left on them, preferably with a renewal option.

Keep in mind that it is very important that you consult your professional advisors on these matters.

VII. Educate yourself (do your homework!)

If you have access to the Internet, use it to learn about various franchises. Most public libraries have a business section where a wealth of information is available about publicly traded companies and many privately held companies. Ask the librarian for help - you can save yourself a lot of time.

A. Department of Corporations

- **Call the Consumer Call Center**

The Department of Corporations regulates the offer and sale of franchises in California and accepts complaints involving violations of the Franchise Investment Law. To file a complaint or to receive general information, please call the Department's toll-free telephone number, 1-866-ASK CORP (1-866-275-2677). You will be connected to the Department's service representative Monday through Friday, from 8:00 a.m. to 5:00 p.m.

- **Visit Us On The Web**

For information concerning the UFOC, franchise laws and rules, and industry organizations, please visit the Department of Corporations' website at www.corp.ca.gov and follow the Securities Regulation Division/Franchise links. This web site provides other useful information including consumer complaint forms.

- **Stop By One Of Our Offices**

The Department of Corporations' offices are located throughout the state including:

Sacramento

(916) 445-7205

1515 K Street, Suite 200

Sacramento, CA 95814-4052

San Francisco

(415) 972-8559

71 Stevenson Street, Suite 2100

San Francisco, CA 94105-2908

Los Angeles

(213) 576-7500

320 West 4th Street, Suite 750

Los Angeles, CA 90013-2344

San Diego

(619) 525-4234

1350 Front Street, Room 2034

San Diego, CA 92101-3697

B. Additional Public Service Agencies

The Federal Trade Commission regulates franchises at the federal level and can be reached at:

Federal Trade Commission

Consumer Response Center

600 Pennsylvania Avenue, NW

Washington, DC 20580

(877) 382-4357

www.ftc.gov

Also, look in your phone book or on the Internet for your local Better Business Bureau for information concerning businesses in your area.

VIII. Conclusion

Investing in a franchise is an important decision which requires serious thought and deliberation. It is the hope of the Department of Corporations that this guide provides you a "tip of the iceberg" insight into franchising. Now it is up to you to continue your research, taking the time to educate yourself. There are a myriad of factors to consider about franchising in general, your chosen franchise, and perhaps most importantly, yourself. Ultimately, you must make the business successful. And remember, no deal is so good that you must act on it immediately or before questions are answered to your satisfaction.

NOTE: Comments or suggestions regarding this guide should be directed to regulations@corp.ca.gov.